

EX PARTE OR LATE FILED

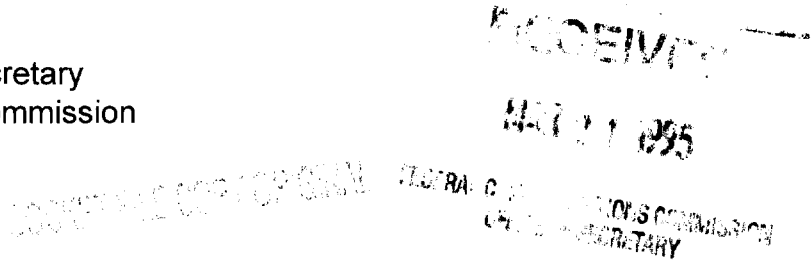
Southern New England Telephone
227 Church Street
New Haven, Connecticut 06510
Phone (203) 771-8514
Fax (203) 624-3549



Eugene J. Baldrate
Director - Federal Regulatory

March 21, 1995

William F. Caton, Acting Secretary
Federal Communications Commission
Room 222
1919 M Street, NW
Washington, DC 20554



Re: Price Cap Performance Review for Local Exchange Carriers

Ex Parte CC Docket No. 94-1

Dear Mr. Caton:

The attached letter was sent today to Kathleen M.H. Wallman, Chief of the Common Carrier Bureau. The letter provides additional support for a continuation of the existing price cap plan for elective companies. Copies were also sent to each of the Commissioners' offices.

I am filing two copies of this response pursuant to the requirements of Section 1.1206(a)(1) of the Commission's Rules.

Very truly yours,

E. Baldrate
EJB

cc: Kathleen M.H. Wallman

No. of Copies rec'd 0
List A B C D E

EX PARTE OR LATE FILED

Southern New England Telephone
227 Church Street
New Haven, Connecticut 06510
Phone (203) 771-8514
Fax (203) 624-3549



Eugene J. Baldrate
Director - Federal Regulatory

March 21, 1995

Kathleen M.H. Wallman, Chief
Common Carrier Bureau
Federal Communications Commission
Room 500
1919 M Street, NW
Washington, DC 20554

RECEIVED
MAR 21 1995
FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

Re: Price Cap Performance Review for Local Exchange Carriers
CC Docket No. 94-1

Dear Ms. Wallman:

The Southern New England Telephone Company (SNET) is submitting the attached information to supplement the record in the above referenced docket.

Specifically, SNET provides information supporting the need for a continuation of the existing price cap plan as a critical option for elective companies. The information includes data with regard to the productivity of elective companies and the additional business risks faced by mid-size and small LECs.

In its deliberations, we ask that the Bureau recognize that SNET elected into price caps based on the known parameters of the then existing plan. Significant modifications to that plan, modifications that dramatically alter the risk reward tradeoffs, change the "rules of the game" for elective companies, and could force SNET to petition for withdrawal from price caps--a course not in the interest of SNET nor, we believe, in the interest of our customers.

Very truly yours,

E. Baldrate pm3

cc: Chairman Hundt and Commissioners Barrett, Chong, Ness, and Quello

Price Cap Performance Review
CC Docket 94-1
Elective Company Productivity and Business Risk

Background:

Southern New England Telephone Company (SNET) submits the following information in support of the need to retain the existing price cap plan as an option for all LECs, but especially for elective companies. SNET elected price cap regulation in 1991 after an extensive evaluation and analysis of the plan's parameters and its impact upon SNET and its customers. At the time of its election, SNET noted to the Commission that, although the productivity factors proposed were aggressive, the risks of the plan were outweighed by the potential for retaining the benefits of cost savings initiatives and eliminating the administrative burdens of rate of return regulation.

Should the Commission now make significant changes to the existing plan, the premise upon which SNET elected into price caps would be violated, and SNET would, in effect, be mandated to participate in a plan not of its choosing.

Fairness Dictates the Long Term Stability in the Plan's Incentives and "Rules of the Road."

The promise of price cap regulation was to provide incentives for increased efficiency in return for the opportunity to retain earnings above that allowed under rate of return regulation. To retain the benefits of efficiency gains achieved, key elements of the price cap plan should not be reset or altered frequently, and further, changes must not destroy the very incentives that they were intended to create. To be effective, incentives must be maintained over a sufficiently long period of time to be reflected in the operations and marketing decisions of the company. This is especially true for small and mid-size companies that are subject to more volatility in the economy and the marketplace. For each elective company, the risk reward relationships of the existing plan were carefully evaluated with respect to the company's ability to financially prosper and fulfill its service obligations. Once the decision has been made to elect into price caps, the Commission should not significantly alter the plan in a way that substantially changes the risk reward tradeoffs, and thus the business risks for elective companies.

Elective Companies Are Fundamentally Different From Mandatory Companies.

Small and mid-size companies differ in significant ways from larger companies and those differences result in increased business risk. Elective companies have historically exhibited lower productivity growth and are more significantly affected by market and economic forces than larger companies.

Productivity of Elective Companies. In its Second Report and Order, the Commission recognized that "assigning one productivity factor on a mandatory basis to all LECs, regardless of size, could prove unduly burdensome to smaller and mid-size telephone

companies" and "acknowledged that small and mid-size companies may have fewer opportunities than large companies to achieve cost savings and efficiencies."¹ Although the Commission declined to mandate a lower productivity factor for small and mid-size companies, it did find that the productivity studies "do provide enough evidence to warrant caution in applying the same high standard to [the small companies] as the largest eight [LECs]."²

Table 1 below provides updated data comparing SNET's Total Factor Productivity (TFP) growth with that of the industry. Data from two studies, while differing in methodology, shows that SNET's achieved TFP growth tends to be lower than the industry. From 1985 through 1992, SNET productivity growth averaged 1.9% as compared to industry growth of 2.4.

Table 1

LEC TFP**		SNET TFP##
Year	% Growth	% Growth
1985	1.1	1.7
1986	2.8	4.8
1987	1.8	4.7
1988	2.1	2.7
1989	2.0	1.4
1990	4.6	-0.7
1991	1.2	-1.4
1992	<u>3.5</u>	<u>0.7</u>
Average	2.4	1.9

** Source: Productivity of the Local Operating Telephone Companies Subject to Price Cap Regulation, 1993 Update, Laurits R. Christensen, Philip E. Schoech and Mark E. Meitzen, Christensen Associates, January 16, 1995.

Source: SNET Total Factor Productivity, Reply Comments of SNET, CC Docket No. 94-1, dated June 29, 1994, Attachment 1.

Thus, SNET's long term productivity growth has been 0.5% less than that of the LECs. Since 1990, there has been an even larger differential. This result is consistent with other independent measures of TFP noted in the LEC Price Cap Order.³ While the specific reasons for the differential may vary from year to year, the practical effect is to limit SNET's ability to achieve real productivity gains at the same rate as the LEC industry.

¹ In the Matter of Policy and Rules Concerning Rates for Dominant Carriers, Second Report and Order, CC Docket No. 87-313, Released: October 4, 1990 (Second Report and Order) at para. 103.

² Id at para. 107.

³ See LEC Price Cap Order, 5 FCC Rcd 6786 (1990), CC Docket No. 87-313.

Scale and Scope of Elective Company Operations Limits Opportunities for Increased Productivity.

Long term improvements in productivity are principally attributable to technological innovations that reduce unit costs. Since small companies are generally less likely or able to fund or have access to the basic research that large companies routinely exploit, they have fewer opportunities to reduce unit costs. Small companies, therefore, must be more selective in their deployment of technological advances. Additionally, large companies, have scale and scope advantages over smaller companies. The result is that large companies have greater opportunity to benefit from technological advances often at a lower cost. Further, large companies can spread fixed costs over larger volumes of activities and multiple state jurisdictions through centralization of service operations and workforce consolidations. The implication of this tendency is that small company productivity gains will tend to be lower than that of larger companies.

The Commission must recognize the unique characteristics of elective companies and insure that they continue to have access to the important benefits of price cap regulation. The benefits of price regulation should not be denied to small and mid-size companies and their customers, but should remain available regardless of how they have fared financially under price regulation. In one sense, it may be more important for companies with only moderate earnings to remain under price regulation because it allows the pricing flexibility and incentives necessary to remain financially viable in an increasingly competitive marketplace.

LEC Earnings Are Not a Reasonable Proxy for Productivity Growth. The Bureau's apparent use of short term earnings growth as a proxy for long term productivity growth is inconsistent with the intent of price regulation, and potentially harms small and mid-size companies. By focusing on earnings rather than the true underlying long term productivity growth, a proposal that increases the productivity factor by the implicit earnings growth rate, not only recaptures currently achieved productivity gains, but also productivity gains of the past. Such an approach diminishes a company's ability to fund future investments necessary to remain competitive. For small and mid-size companies that do not have the diversified operations of larger companies, the resulting reduction in resources may limit or slow productivity improvements.

Elective Companies Face Additional Business Risk Because of Their Size and Geographic Concentration.

As a single state company, without geographic diversity, SNET faces significantly more business risk than larger more diversified companies. Negative economic cycles, geographic concentration, limited scale and scope of operations and the level of competition all tend to have an exaggerated impact on elective companies. For example, SNET was required to file for a lower formula adjustment in 1992 as a result of

the New England recession. The Commission recognized these differences in its Second Report and Order.⁴

The volatility of the Connecticut economy, coupled with the geographic concentration of its customers, are key factors that increase SNET's business risk. Attached are several charts that contrast the major components of the Connecticut economy with the nation at large. These charts dramatically portray the degree of this volatility.

Geographic Concentration Makes Economic Cycles More Volatile. Over the last two decades, the Connecticut economy has encountered pronounced volatility due to a combination of large swings in the defense industry, proportionately larger corporate downsizings, exaggerated housing cycles, a regional credit crunch, major structural shifts that have undermined the manufacturing sector and greater variance within regional consumer confidence ratings.

The volatility of the Connecticut economy vis-a-vis the national economy is shown in **Chart 1**. The chart compares changes in the Connecticut Economic Index (CEI), a reliable indicator of the State's overall economic health, with those of the Gross Domestic Product (GDP). *Gains in the CEI have a tendency to be larger in economic upswings and more pronounced during recessions relative to the real GDP.* For instance, in 1984 the CEI rose 8.2%, whereas real GDP advanced somewhat less than 6.2%. During the recession of 1974-75, and more recently the 1989-92 recession, the CEI posted drops of 4.6% and 2.5% respectively, whereas real GDP recorded a mild decline of 0.8% and 1.2% during the same periods.

A good measure of Connecticut's economic strength in the 1980's and weakness in the 1990's can be traced to major swings in U.S. defense spending. During the Reagan years, Connecticut benefited from the defense build-up as defense contract rose 6.5% in 1984 and 1.5% in 1985. **Chart 2**, however, shows that *amplified swings in contract awards during the late 1980's and early 1990's were responsible for manufacturing employment declines of 5.0% in 1990 and 5.2% in 1992.* In fact, employment within transportation equipment, which represents a large share of the State's defense oriented employment, has dropped by 36% from a level of 86,670 in 1987 to just 55,200 in early 1995.

Trends in Connecticut's broad employment picture have contrasted sharply with those of the nation. Connecticut has gained back only 11,600 of the 164,000 jobs lost during this past recession, equating to a recovery rate of 7.1%. In contrast, as **Chart 3** depicts, the domestic economy has gained back 7 million jobs since the 1992 lows after recording losses of 1.8 million. In fact, Connecticut not only lags domestic job expansion by a wide margin on a relative basis, but also that of neighboring New England states. **Chart 4** portrays U.S. and Connecticut employment trends in recent years dating back to 1988 and shows *Connecticut went into recession long before the U.S. economy did, and has lagged in economic recovery.*

⁴ Second Report and Order at para. 260 (scale and scope of operations) and at paras. 114-116 (geographic differences).

The housing market has also exhibited pronounced variability versus the national economy. A speculative bubble encountered in the mid-1980's accelerated housing values and creating new construction jobs. However, a sizable inventory overhang in single-family and condominium markets during the late 1980's and early 1990's caused a decline in housing prices along with a drop in construction employment. **Chart 5** shows how Connecticut housing activity rose almost three times its 1982 level, nearly twice the national average, and then fell sharply relative to the nation.

Finally, *consumer confidence exhibits the same volatility as other key economic measures in Connecticut*. Recently, lower consumer confidence, due mainly to the erosion in the regional labor and housing markets, has affected consumption. **Chart 6** shows that consumer confidence readings for New England fell 86% from early 1988 through late 1990, whereas U.S. measures reflected only a 46% drop.

Customer and Market Concentration Increases Vulnerability to Competition. The General Assembly of Connecticut enacted Public Act 94-83, effective July 1, 1994, with the expressed intent of providing greater choice in the prices, products and providers of telecommunications service. Participants in the regulatory process following passage of Public Act 94-83 have expressed a significant interest in provisioning offerings, including local service, in direct competition with the state's telephone companies. At the same time, SNET has expressed a willingness to accept the inevitability of such competition, and has embraced competition as a part of its vision of the future.

Competitive provisioning of telecommunications service is directly related to the potential profitability of the Connecticut market as part of the Northeast Corridor between New York City and Boston. Further, Connecticut is among the most densely populated states in the nation.⁵

⁵ 1994 Statistical Abstract of the United States, US Department of Commerce.

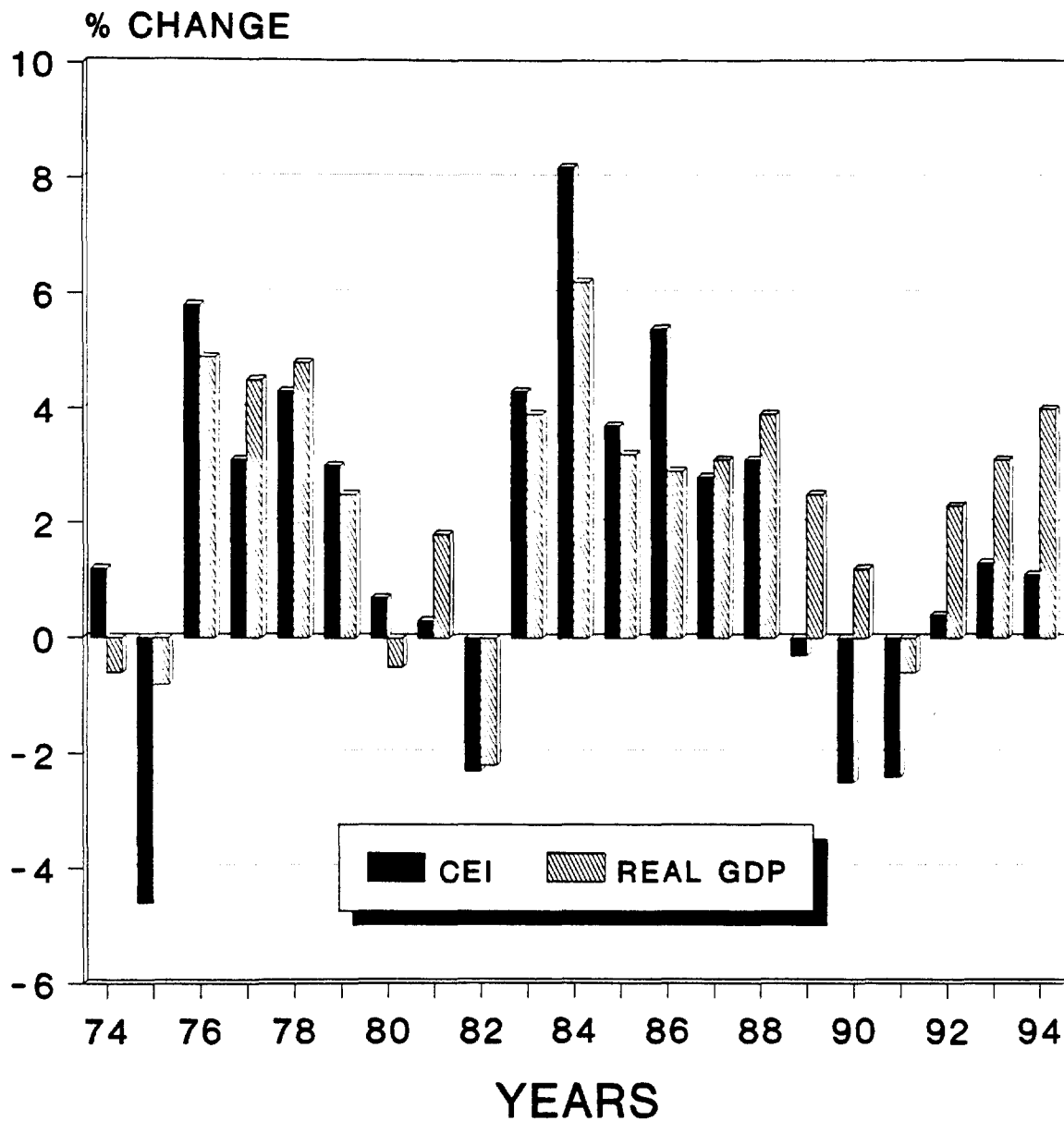
Conclusion and Summary.

The Commission should recognize that any changes to the existing price cap plan need to consider the unique circumstances of the elective companies. The underlying long term productivity for LECs is not appropriately measured by short term earnings growth, but rather by the relationship of their productive inputs to outputs as measured by total factor productivity. It is clear that productivity studies presented in the original price cap proceeding gave the Commission reason to proceed with "caution" in mandating an industry productivity factor for small and mid-size companies. The data provided by SNET today supports and reinforces the Commission's original concerns and should provide a basis for maintaining the current price cap plan for elective companies.

The issue of business risk for elective companies also supports the continued availability of today's plan for elective companies. The historic volatility of the Connecticut economy, the limited opportunities for significant additional concentration of the workforce, legislation that will foster increased competition and geographic and market concentration, all magnify the business risks faced by elective companies such as SNET.

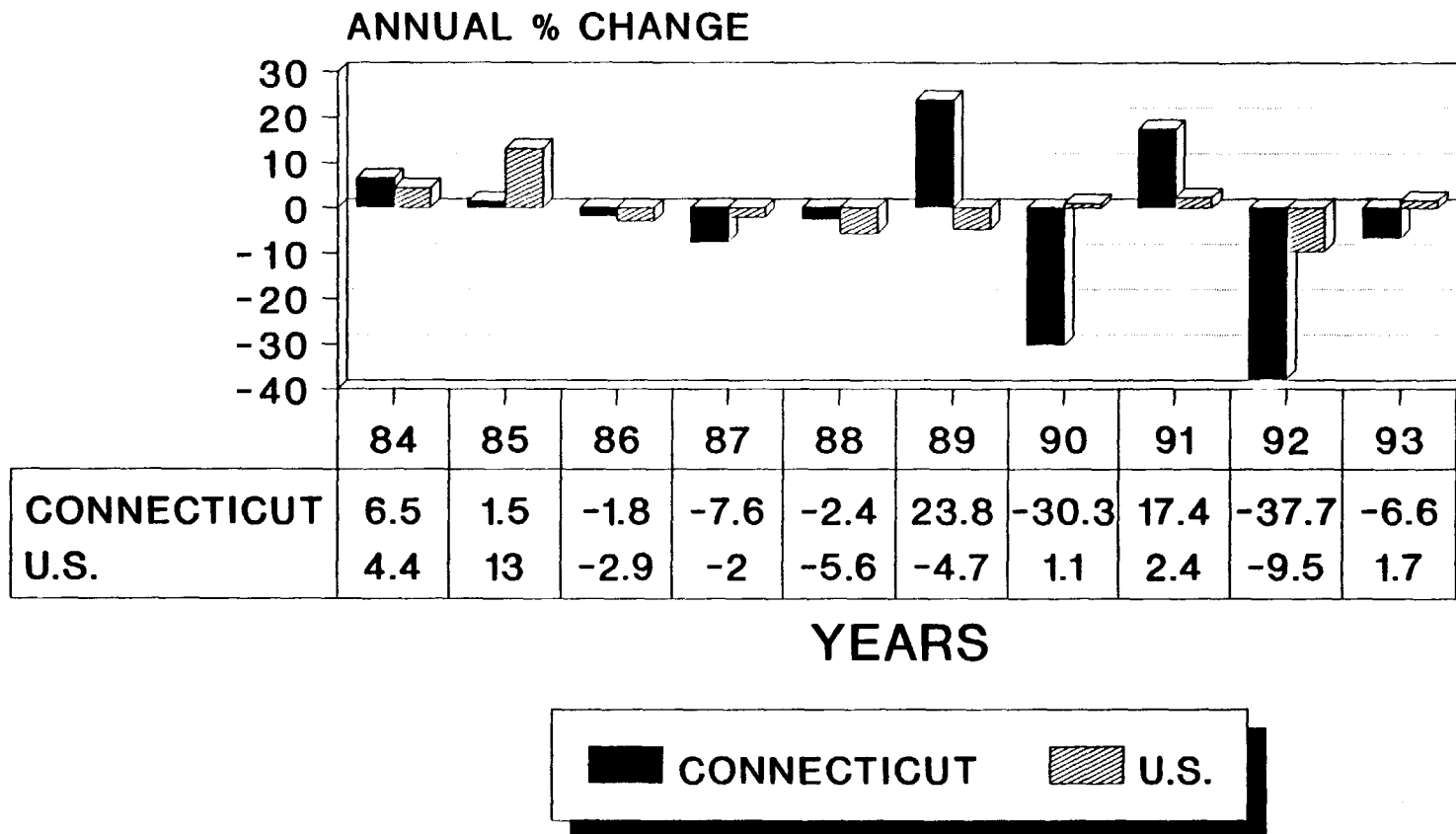
The Commission should continue to recognize the fundamental differences of small and mid-size companies, including their additional business risks, and should allow elective companies to have continued access to the price cap plan that they elected into.

1. CONNECTICUT ECONOMIC INDEX GROWTH VS. REAL GDP GROWTH (Annual % Change, 1974-1994)



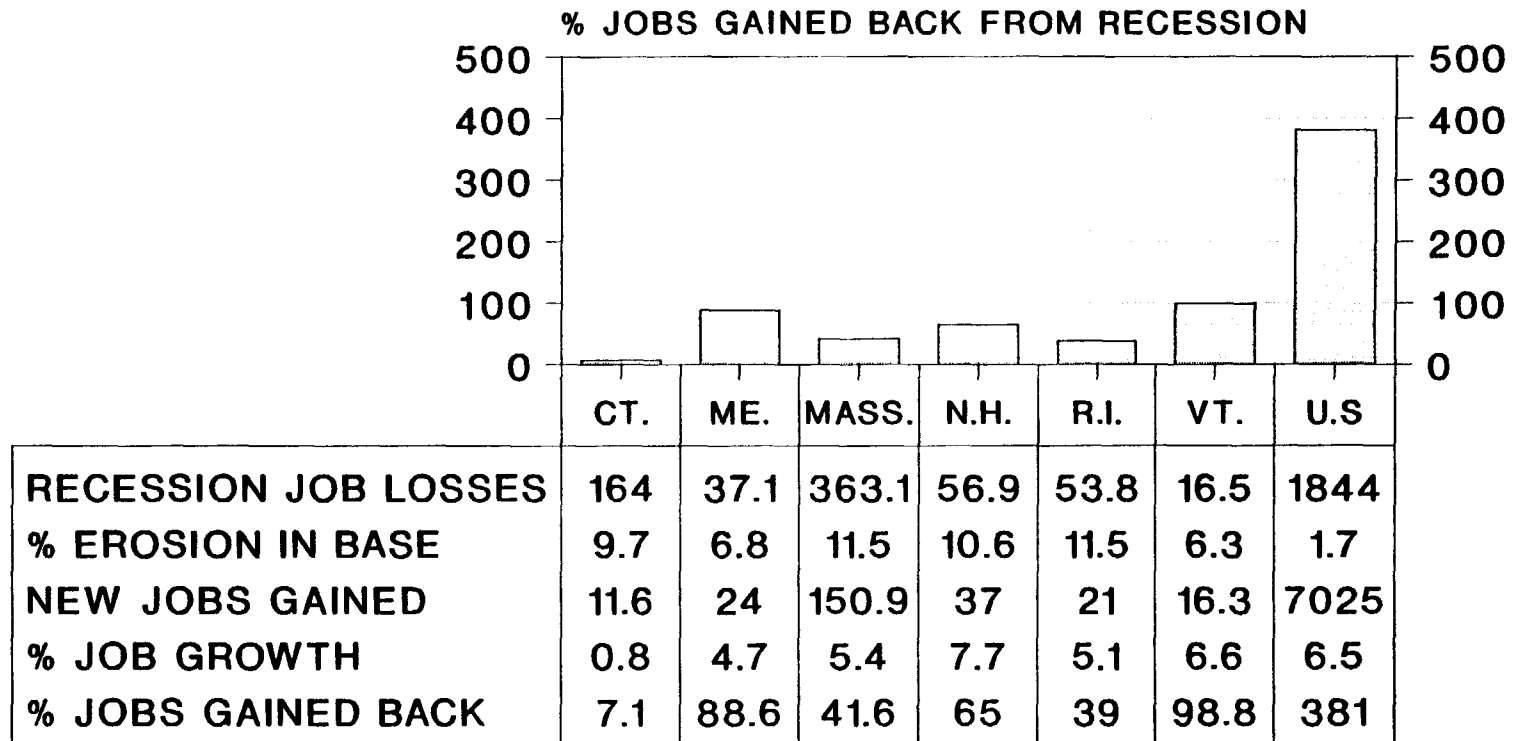
Sources: SNET MKT ANALYSIS & FCSTG,
U.S. COMMERCE DEPT.
NOTE: REFLECTS 3/95 CT. LABOR REVISIONS

2. DEFENSE CONTRACT AWARDS CONNECTICUT VS. U.S. (ANNUAL % CHANGE, 1984-1993)



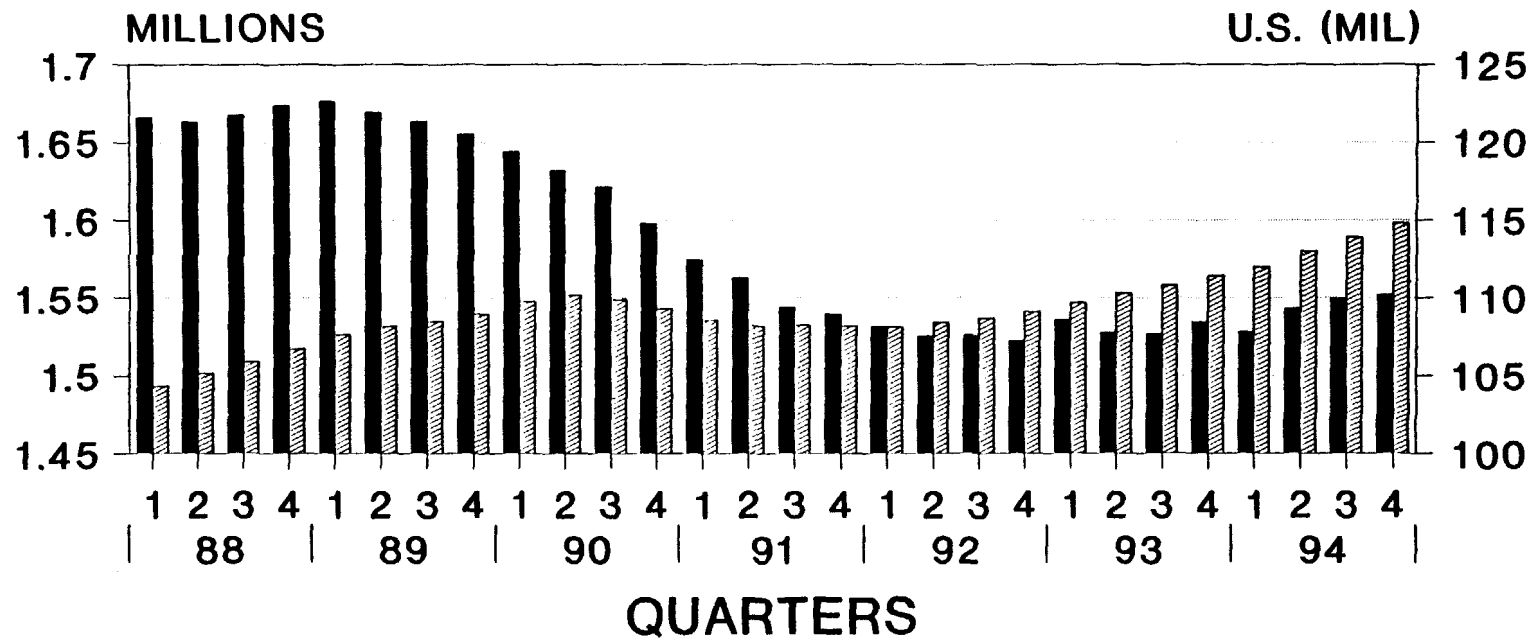
**SOURCE: 1995-97 CT. GOVERNOR'S
ECONOMIC REPORT**

3. ABSOLUTE & RELATIVE JOB GAINS FOR ALL NEW ENGLAND STATES & U.S.



NOTE: REFLECTS UNREVISED DATA THRU 12/94
SOURCE: U.S. DEPT. OF LABOR

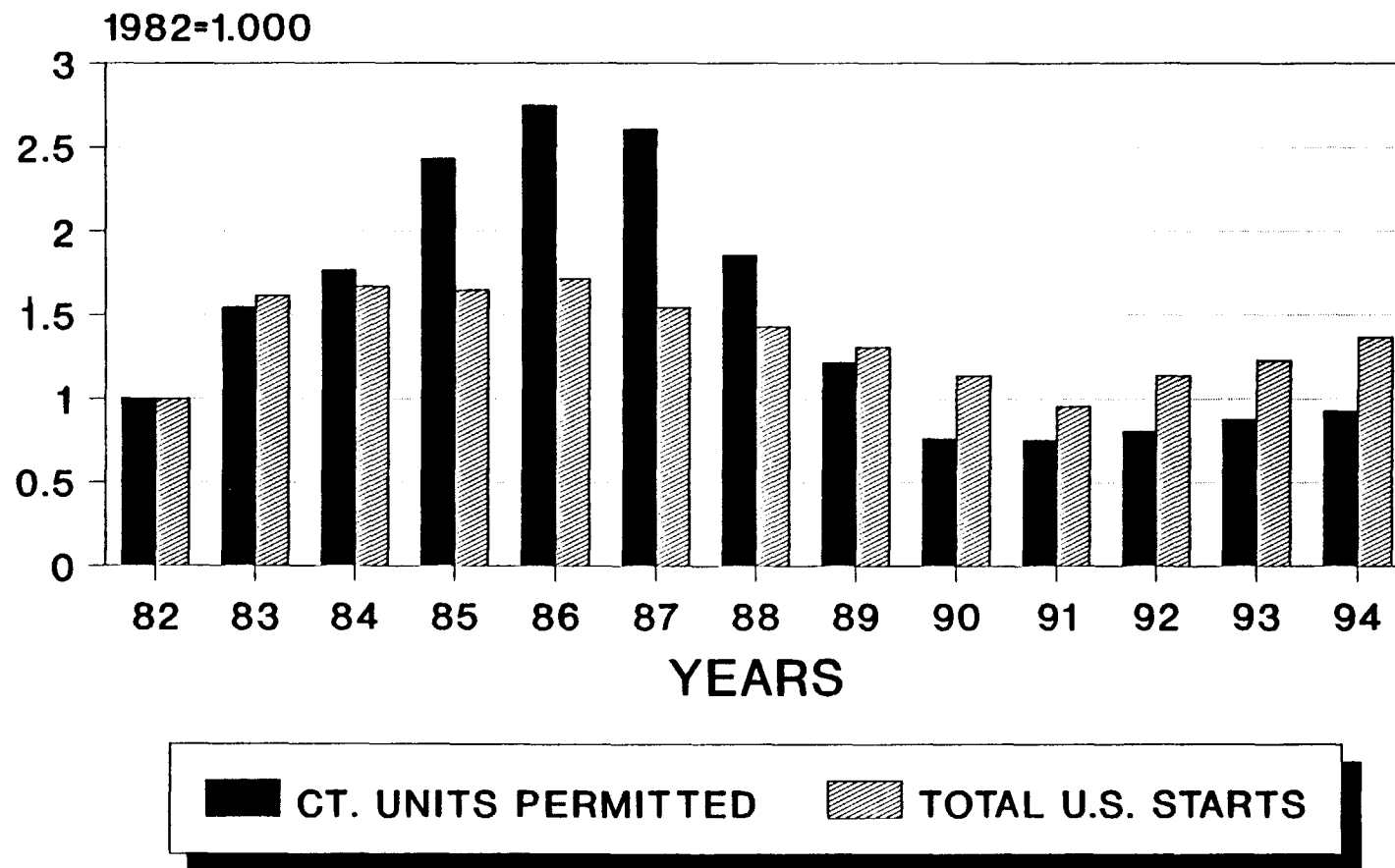
4. CONNECTICUT TOTAL NON-AG. EMPLOYMENT VS. U.S. NON-AG. EMPLOYMENT (1988Q1 - 1994Q4)



CT. EMPLOYMENT
 U.S. EMPLOYMENT

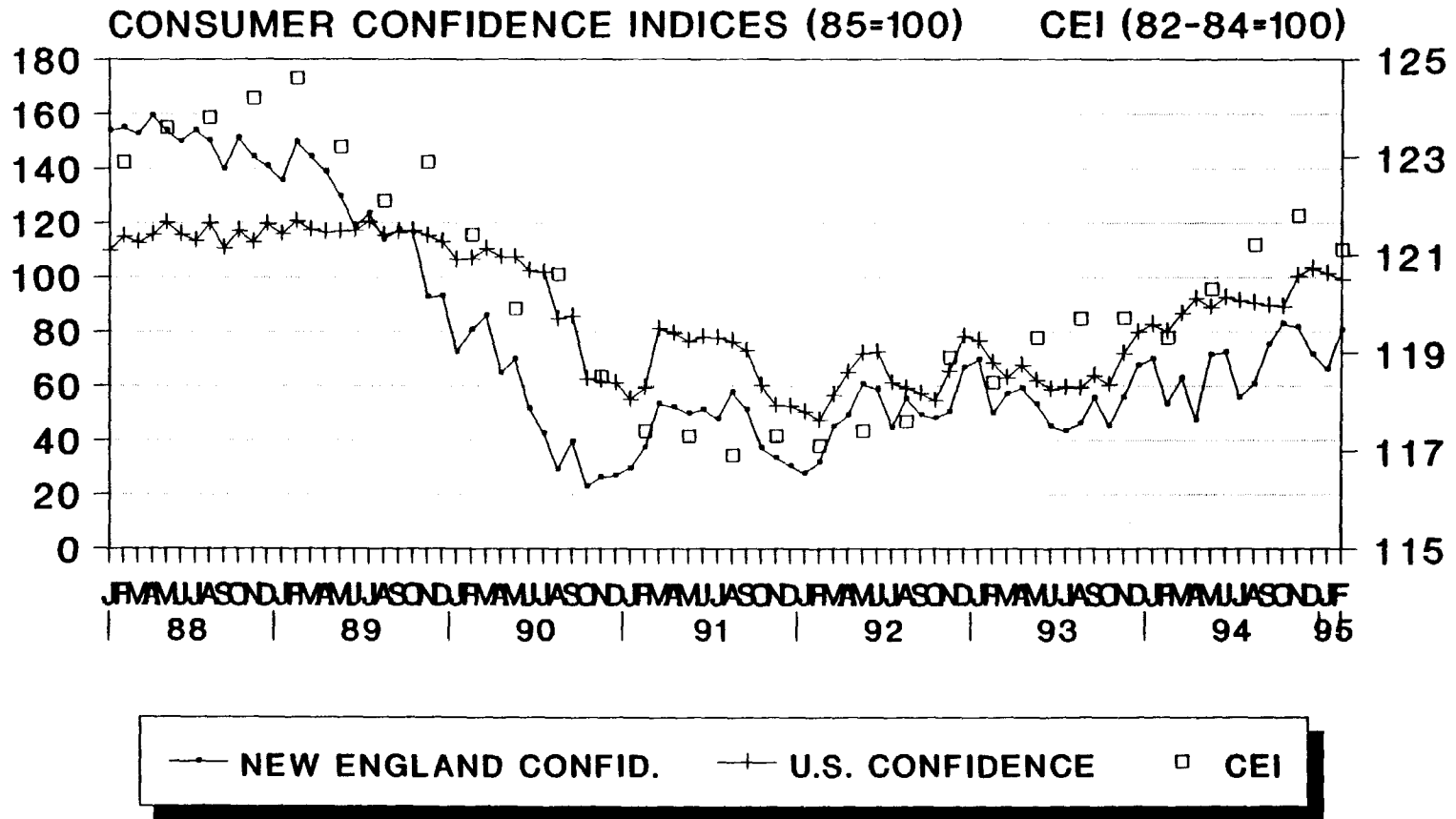
SOURCES: CT LABOR DEPT.,
 U.S. BUREAU OF LABOR STATISTICS
 NOTE: REFLECTS 3/95 CT LABOR REVISIONS

5. HOUSING MARKET COMPARISON (CT. VS. U.S/ 1982=1.000)



SOURCES: U.S. COMMERCE DEPT.,
CT. HOUSING DEPT.
NOTE: REFLECTS PRELIM 94 TOTALS

6. CONSUMER CONFIDENCE U.S. VS. NEW ENGLAND/JAN88-FEB95



SOURCES: CONFERENCE BOARD
 SNET MKT ANALYSIS AND FORECASTING
 NOTE: REFLECTS 3/95 CT. LABOR REVISIONS